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The Belden Center for Private Enterprise Education  
Harding University School of Business  
Searcy, Arkansas

# The Entrepreneur

## THE FEDERAL BUDGET PROCESS Why It Is Broken and How It Can Be Fixed

by

James D. Gwartney and Richard E. Wagner

### 1989 AMERICAN INCENTIVE SYSTEM CALENDAR-- A Daily Chronicle of Enterprise

In a joint venture project with Louver Manufacturing Company (Lomanco) of Jacksonville, Arkansas, the Harding University Students in Free Enterprise Economics Team presents the 1989 "AMERICAN INCENTIVE SYSTEM CALENDAR--A Daily Chronicle of Enterprise."

The 1989 "AMERICAN INCENTIVE SYSTEM CALENDAR" offers 365 brief reminders of great enterprising events and relevant comments on the idea of freedom applied to the marketplace. It should hang on the walls of offices, factories and school rooms all over the country. A limited amount of copies are available for \$2.00 to cover printing, postage and handling costs.

### STAYING ON TOP IS HARDER THAN GETTING ON TOP

The Harding University Economics team will attempt to win its seventh first place trophy at the National Students in Free Enterprise Competition next summer. The university economics teams have won first place six times at the nationals which were started in 1978. Harding teams, the winningest in the country to date, were national runners-up in 1978, 1983, 1986, and 1988.

The 1989 team is composed of Ron Cook, Co-Chairperson from Searcy, Arkansas; Gabrielle DeMatteis, Co-Chairperson from Richmond, Virginia; Drue DeMatteis from Richmond, Virginia; Jim Hull from Columbus, Ohio; Karen Norwood from Searcy, Arkansas; Sheila Wood from Mabelvale, Arkansas; and their sponsor, Dr. Don Diffine, Professor of Economics and Director of the student-staffed Belden Center for Private Enterprise Education.

Every president elected during the last two decades has promised to bring federal spending under control and reduce the size of the budget deficit. All have failed, in both tasks. Between 1965 and 1985, federal expenditures as a share of GNP rose from 17.6 percent to 24.0 percent. The non-defense component of federal spending expanded even more rapidly, soaring from 10.1 percent of GNP in 1965 to 17.6 percent in 1985. Since 1960 the federal budget has been in deficit 26 out of the 27 years. By way of comparison, during the 1947-1960 period, there were seven budget surpluses and seven budget deficits.

The budget process reached new lows in the 1980s. The annual charade goes along the following lines. The President submits a budget that includes a large deficit. After numerous committee hearings and much shadow boxing, Congress eventually passes a budget resolution specifying broad categories of spending. After the budget resolution is passed, separate committees on appropriations and revenue hammer out specific items in the budget. Theoretically, a congressional rule bars floor consideration of appropriations beyond the amount specified in the budget resolution; but everybody knows this is a paper lock.

After all, the House has waived this rule nearly 500 times during the decade. The time clock continues to tick. Before the appropriation bills are passed the new fiscal year begins. At the last minute, a continuing resolution is passed in order to keep the government from closing down. This borrows a little time. A couple of months after the fiscal year has started, Congress eventually passes a gigantic appropriations bill (last year's

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bill was 1194 pages long) lined with lots of lard benefitting key senators and representatives in positions of power. The president must either sign the bill or close down the government.

All through this process, politicians from both parties are on television telling us how they are struggling to control the budget deficit without cutting into the muscle of vital government programs. However, closer inspection reveals that this tale of struggle is a total misrepresentation of reality.

The many bizarre items in recent budgets undermine the credibility of the tale. A North Dakota senator inserts a \$10 million sunflower subsidy program for growers in his state. A Maryland congressman arranges for \$200,000 to be paid to the City of Frederick for a ransom it paid to Confederate forces in 1864. A Nebraska representative pushes through a \$20 million study to see if residents in his district qualified for disaster relief. During the waning hours prior to the passage of this year's budget, Senator Daniel Inouye of Hawaii even sneaked in \$8 million to build a school in France for Jewish refugees.

These are small items when looked at individually. But they are illustrative of the larger problem: the federal government's budget process lends itself to inclusion of spending measures which promote private interests and the political welfare of legislators at the expense of the general taxpayer.

## **WHY THE CURRENT BUDGET PROCESS IS NOT WORKING**

Effective decisionmaking processes must confront those who make choices with incentives that encourage them to use resources wisely. Such processes must acknowledge explicitly that choices inescapably entail costs: to choose one thing necessarily entails the sacrifice of some valued alternative. Rational choice is possible only when those who make choices are confronted with a constraint that forces them to consider the cost of each option while seeking to choose the option that provides the most satisfaction.

The current budgetary process is not working precisely because it does not force our legislators to make wise choices. There are four major reasons why this is so.

**1. The current budget process blurs costs and thereby makes it difficult to compare benefits relative to costs on a program-by-program basis.** A decision to adopt a program is decided independently from a decision to levy taxes to fund the program. Worse still, Congress decides if a program should be adopted before it deals with the funding issue. Rather than deciding how much to spend and then choosing possible options within the budget constraint, Congress decides which programs to adopt and then tries to figure out how to finance them. Of course, this is precisely the reverse of what we do in the

business and household sectors. In the private sector, we estimate the resources available during a budget period and then choose how best to allocate them.

**2. Under current rules, the federal budget constraint is soft.** In their personal choices, people confront a relatively firm budget constraint. If households continue to spend beyond their means, their eventual inability to pay their bills and the accompanying loss of credit worthiness will impose a reality check. Similarly, if businesses consistently spend beyond their revenues, losses will result, stock value will decline, and, if necessary, bankruptcy will eventually terminate the profligacy.

The current budget process of the federal government contrasts sharply with that of the private sector, in that the persons (legislators) making choices confront a much softer budget constraint. This is not to deny that a budget constraint ultimately exists, for it surely does. An increase in federal spending on one program **must** imply either a decrease in spending on other programs or an increase in taxes or borrowing--which in turn will require a decrease in personal spending. But the constraint is faced only indirectly and remotely within the federal government's budget process, whereas it is direct and immediate in personal choices.

**3. The current budget process plays into the hands of interest groups seeking private gain at public expense.** Our first two points dealt with the general reduction in rationality that arises because there is no simultaneous consideration of the benefits and costs of public programs. Even if everyone had the same interests and evaluations concerning different possible spending programs, the budgetary process would be flawed because of its failure to support rational consideration of budgetary options. As a result people will support larger public spending than they would support if they had to confront directly the full cost of that spending.

It is easy to see why the current process favors special interest groups. Since their personal stake is large, members of the interest group (and their representatives) have a strong incentive to inform themselves and their allies and to let legislators know how strongly they feel about an issue of special importance. Many of them will vote for or against candidates strictly on the basis of whether they support their interests. In addition, such interest groups are generally an attractive source of campaign resources, including financial contributions. In contrast, most other voters will care little about a special interest issue. For the non-special interest voter, the time and energy necessary to examine the issue will generally exceed any possible personal gain from a preferred resolution. Thus, most non-special interest voters will simply ignore such issues.

**4. The current budget process promotes the transfer of resources from production into rent seeking.** Modern public choice theory refers to actions designed to promote one's interest at the expense of others as rent seeking. Rather than trying to build that proverbial



better mousetrap, people might lobby for tariffs or quotas on imports, they might lobby a safety commission to ban lower cost, competitive mousetraps, or they might lobby to prevent people from making mousetraps at home. Rather than applying resources to the creation of wealth, rent seeking uses resources to redistribute previously created wealth.

## **A CONSTITUTIONAL AMENDMENT THAT WOULD MITIGATE THE PROBLEM**

The federal government must return to fiscal responsibility. There can be little doubt about this. But it would be a mistake to think that all we need is more budgetary tinkering by the legislature. To the extent our budgetary problems are symptomatic of an underlying erosion of constitutional limitations on congressional budgetary authority, effective remedy would seem to require not still more legislation but a reassertion of constitutional control over legislative authority.

The case for constitutional reformation rests on a recognition that there are situations in which even though people's pursuit of their own interests will lead to generally undesirable outcomes, individually they will have little incentive to act differently because to do so would leave them even worse off. Ordinary legislative processes will not restrain the budgetary excesses that arise from within a system of unlimited democracy, because legislators are merely exploiting the opportunities that existing constitutional rules offer. Better outcomes require alternative constitutional rules that foreclose some of the natural excesses of a system of majoritarian democracy.

What changes in budgetary procedures would bring the self-interest of the political players more closely into harmony with the general welfare? There are several specific actions that would move us in that direction. We should like to outline the structure of a comprehensive reform in budget procedures that would do much to alleviate the major deficiencies of the current process. We do this not out of any sense that this is the only way to accomplish budgetary reform, but out of a recognition that it is necessary to get into some examination of specifics in order to advance the discussion of budgetary reform. We refer to this proposal as the **Taxpayer Protection Amendment**. There are five provisions of this amendment.

**1. A two-thirds Congressional majority would be required for approval of an increase in either taxes or debt.** The main impact of this provision would be to curtail the scope for rent seeking, which in turn is the contemporary equivalent of what James Madison called the "violence of faction" in *Federalist* No. 10. The more inclusive the degree of consent that is required to enact budgetary measures, the less is the scope for winning factions to enact appropriations levels that they would not support if they had to bear the cost themselves, but

would be only too happy to enact if they can place the burden of payment on someone else.

**2. Prior to the passage of any appropriation bill and at least five months before the beginning of each fiscal year, Congress and the President would be required to set a constraint for the level of fiscal year spending.** Once the spending level constraint is passed, any spending beyond the limit would require the approval of a three-fourths majority of both houses. The President would be required to submit a proposed budget constraint figure to Congress at least eight months prior to the beginning of the fiscal year. In order to assure compliance, the President and each member of Congress would be fined \$5,000 per day if the budget constraint was not passed within the required time limit.

**3. Two-thirds approval of both houses would be required for passage of any legislation that mandates spending by states, private businesses or individuals.** This provision is necessary in order to prevent Congressional use of mandated expenditures as a means of escaping the limits imposed by the budget constraint. After all, whether the federal government spends \$1 billion on a program to subsidize prescription drug purchases for the elderly or, alternatively, requires states to set up such programs as a condition for continuing to receive highway aid the federal government is having an identical economic impact. Restricting the ability of the federal government to directly subsidize particular citizens at general expense will lead naturally to a search for indirect ways of doing the same thing.

**4. Any new program requiring a budget expenditure must simultaneously provide for a new source of revenue (additional taxes or user charges) which will finance the program.** This requirement of a "marginally balanced budget" will assure that all new spending programs consider the cost, as well as the benefits, as part of a single package. This linking of benefits and costs when a program is considered will provide public sector decision-makers with an incentive structure more consistent with that of the private sector. Most assuredly it will result in more careful consideration of spending proposals and sounder public sector decisionmaking than the current process.

**5. Finally, an item-reduction veto should be given to the President.** Note that we have said "item-reduction veto" and not "item veto" or "line-item veto." The President pretty much had an item veto prior to the Congressional Budget and Impoundment Act of 1974, in that he could impound spending on specific projects. Forty-three governors presently have item veto authority, and it might seem that such an authority would be an effective device for curbing budgetary excesses. However, the situation is a little more complex than this, which makes it important to distinguish between an item veto, in which the executive can either accept or veto a particular item and an item-reduction veto, in which the executive can also insert a lower figure without vetoing the item entirely.



## CONCLUSION

A budget process consistent with economic efficiency is more dependent upon our ability to develop and institute sound rules and procedures than it is upon our ability to elect "better" people to political office. Unless we get the rules right, the political process will continue to be characterized by special interest legislation, bureaucratic inefficiency and the waste of rent seeking.

The political incentive structure is like the law of gravity. Just as Republicans and Democrats both fall at 32 feet per second squared, so too do both engage in special interest politics and other socially wasteful political behavior when the political incentive structure encourages them to do so.

Taken as a package, the **Taxpayer Protection Amendment** would reduce the power of special interests, the attractiveness of rent seeking and the centralization of power toward Washington. In a more general context, it would be a modest step toward restoration of government based on agreement and mutual gain, rather than majority rule and the power to plunder. No doubt, many will feel that a reform of the type suggested here is unrealistic because its passage would require the support of persons in positions of political power.

However, this obstacle may be more apparent than real. The current system more or less forces politicians to abuse their electoral responsibility--to seize funds from taxpayers in order to provide political favors to organize interest groups in exchange for political support. How many legislators really want to be bagmen for special interest groups? If they are provided an option, a surprising number might well be supportive.

The intellectual folly of our age is the view that democratic elections are all that is necessary for the preservation of personal liberty. History teaches that this view is false. The ordinary political process must be restrained. Constitutional rules based on the mutual agreement must be instituted and followed.

Unless we begin to recognize the folly of the "everything is up for grabs" conceptualization of government, increasing factionalism and growing dissatisfaction with the results of public policy are in the offing, as Madison warned in **Federalist No. 10**. Now is the time to learn or, more accurately, to relearn the merits of a political economy based on principles and rules of mutual agreement. The freedom and prosperity of America are dependent upon our ability to do so.



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